

Private Letter Ruling: Taxpayer engaged in the business of purchasing customer accounts receivable from affiliated corporations is a sales finance company required to apportion its business income as a financial organization. Interest received from Illinois customers at the taxpayer's lockbox in Illinois will be included in the Illinois numerator.

November 2, 1999

Dear:

This is in response to your letter dated September 23, 1999, in which you request a Private Letter Ruling on behalf of xxxxxxxxxxxxxxxxxxxx. Review of your request for a Private Letter Ruling disclosed that all information described in paragraphs 1 through 8 of subsection (b) of the enclosed copy of Section 1200.1120 appears to be contained in your request. The Private Letter Ruling will bind the Department only with respect to xxxxxxxxxxxxxxxxxxxx for the issue or issues presented in this ruling. Issuance of this ruling is conditioned upon the understanding that neither xxxxxxxxxxxxxxxxxxxx nor a related taxpayer is currently under audit or involved in litigation concerning the issues that are the subject of this ruling request.

The facts and analysis as you have presented them are as follows:

We are writing to request a private letter ruling on behalf of our clients, xxxxxxxxxxxxxxxxxxxx (hereafter "xxx") and xxxxxxxxxxxx xxxxxxxxxxxx (hereafter "xxxxxxxxxxxx"), under 2 Ill. Adm. Code Section 1200.110, in relation to their Illinois income tax liabilities described below.

xxx, which is headquartered in xxxx, and its wholly owned subsidiaries are engaged in the design, manufacture and sale of office furniture and hearth products. xxx and its subsidiaries currently file a consolidated return for Federal income tax purposes and a unitary return for Illinois corporate income tax purposes. The following companies are currently included in the Illinois unitary return: xxxxxxxxxxxxxxxxxxxx xxxxxxxxxxxxxxxxxxxx xxxxxxxx xxxxxxxx xxxxxxxx xxxxxxxx xxxxxxxx xxxxxxxx xxxxxxxx The xxxxxxxx xxxxxxxx, xxxxxxxxxxxx xxxxxxxxxxxx, xxxxxxxxxxxx, xxxxxxxx xxxxxxxxxxxxxxxxxxxx xxxxx, xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx, xxxxxxxxxxxxxxxxxxxx, xx xxxxx xxxxxxxxxxxxxxxxxxxx, xxxxxxxxxxxxxxxx, xxxxxxxxxxxxxxxxxxxx, and xxxxx xxxxxxxx.

In order to provided a vehicle for greater centralization of the credit and collection function and to achieve administrative efficiencies, xxx created a new wholly owned subsidiary, xxx xxxxxxxx, on December 17, 1998 to handle the credit and collection function for affiliates in the office furniture group. xxxxxxxxxxxx entered into a management and administrative services agreement to provide cash accounting and credit services to this group effective January 4, 1999. xxx and its subsidiaries are now planning to sell without recourse all accounts receivable generated from the sale of office furniture to customers to xxxxxxxxxxxx. The sale of accounts receivable to xxxxxxxxxxxx will provide xxx and its subsidiaries with cash for operational needs.

xxxxxxxxxxxxx will not be eligible for inclusion in the xxxxx Federal consolidated corporate tax return because xxxxxxxxxxxx will be owned by a partnership in which xxx will be the 95% partner.

The Illinois income tax issues on which we would like to have your comment are those that relate to taxation of xxxxxxxxxxxxxxxx, in particular its status as a financial organization under Section 1501(a)(8) of the Illinois Income Tax Act (hereafter "IITA") and the apportionment methodology that would result under Section 304(c) of the IITA. Immediately below are the specific facts which we believe are relevant to those issues.

FACTS

- 1) xxx and its subsidiaries sell products throughout the United States to wholesalers, dealers, superstores, warehouse clubs, federal, state and local governments and end-users. There are customers located in Illinois, and in most other states. xxx and its subsidiaries' apportionment in Illinois had been based on their respective property, payroll and sales factors. This was also the case in most of the other states in which xxx and its subsidiaries filed income tax returns. xxx files its Illinois income tax returns as a member of a unitary business group. xxx and its subsidiaries' apportionment in Illinois will now be based primarily on its sales beginning with its year ending January 3, 1999. (Under Section 304(h) of the IITA, the single sales factor will be fully phased in for years ending on or after December 31, 2000).
- 2) Many non-government sales by xxx and its subsidiaries are to customers who are corporations with their respective headquarters being located at various points throughout the United States. Certain of the dealers are sole proprietorships or partnerships that operate out of one or more locations in a single state. In terms of customer base, approximately 99% of the sales made by xxx and its subsidiaries are at wholesale and the balance being at retail.
- 3) Sales by xxx and its subsidiaries are almost exclusively non-cash transactions. This results in a substantial amount of accounts receivable. xxx or its subsidiaries make Uniform Commercial Code general filings and assignment of proceeds filings for sales in all states in their own name.
- 4) Customers of xxx and its subsidiaries currently make payments by check or electronically to lockbox locations in Illinois and xxxxxxxx. The lockboxes are operated by different financial institutions. The location of the lockboxes and the determination of which customers will be served by each has been a matter of careful study designed to minimize the time required for customer payments to reach the banking system. The services performed by the financial institutions in Illinois and xxxxxxxx include opening remittances, depositing the cash, and providing a tape to facilitate cash application and reconciliation. After the sale of accounts receivable is instituted, these lockboxes will be maintained with customers instructed to pay xxx xxxxxxxxxx. The financial institutions will continue to perform the same services they currently perform, but will do so on behalf of xxxxxxxxxxxxxxxx to the extent it has purchased the receivables of xxx and its subsidiaries.

- 5) xxxxxxxxxxxxxxxx purchase of accounts receivable will be at fair market value which is below their face amount. The difference between fair market value and the face amount will consist of dilution and discount. Dilution represents amounts that xxx and its subsidiaries would not collect on a receivable in the ordinary course of business. Dilution includes items such as high volume discounts or rebates, fees paid to credit card companies and various discounts for early payment which xxx and its subsidiaries provide to customers. The discount reflects prevailing market interest rates at the time receivables are purchased, the expected number of days to collect those receivables, the credit worthiness of the customers whose receivables are purchased and the costs associated with collection and cash application. Appropriate dilution and discount percentages to be applied to the accounts receivable purchased by xxxxxxxxxxxxxxxx will be subject to periodic reevaluation and revision.
- 6) From the viewpoint of xxx and its subsidiaries the factoring of accounts receivable to xxxxxxxxxxxxxxxx would provide xxx and its subsidiaries with cash that they can use for operational purposes.
- 7) There are no present plans in connection with the proposed sale of accounts receivable to xxxxxxxxxxxxxxxx to alter the lockbox locations or electronic funds transfer arrangements that are described in Paragraph 4, though the number of lockboxes could change from time to time, because of changes in customer payment and banking system patterns.
- 8) xxxxxxxxxxxxxxxx is headquartered in xxx. This is xxxxxxxxxxxxxxxx primary place of business and the only location at which it has employees. The employees duties include cash application performed by two cashiers and a supervisor and credit work performed by five managers who visit customers to discuss financial status, credit improvements and occasionally collect on delinquent account. There is also a lease of real property in Illinois. xxxxxxxxxxxxxxxx may also have a relatively small amount of interest income on short-term investments of cash collections pending purchase of new accounts receivable in addition to the income it will earn as a result of the recovery of portions of the discount on the accounts receivable which it has factored. xxxxxxxxxxxxxxxx will file corporate income tax returns in xxxx. In addition, xxxxxxxxxxxxxxxx will be included in xxxxxx current unitary filings where permitted or required by state law. It is unclear whether the activities of xxx xxxxxxxxxxxxxxxx employees will create filing responsibilities in xxxxxxxx, where the lockbox is located, or other states.

CONCLUSIONS [of the Taxpayer]

For reasons that are explained below, we believe from a review of the IITA that xxxxxxxxxxxxxxxx would be required:

- 1) to file an Illinois income tax return and
- 2) to apportion its income to Illinois based on the percentage that

the interest payments which it receives at the Illinois lockbox from xxx and its subsidiaries' wholesaler/distributor customers that are commercially domiciled in Illinois and from xxx and its subsidiaries' end-use customers that operate in Illinois bear to its total interest payments received.

However, in view of the limited official pronouncements by the Department and the lack of case law authority on certain of the issues, we would appreciate receiving from you a private letter ruling under 2 Ill. Adm. Code Section 1200.110 confirming our conclusions based on the analysis presented below.

ANALYSIS [of the Taxpayer]

xxxxxxxxxxxxxxxxxxxx Status as a Sales Finance Company

Section 1501(a)(8)(C) of the IITA, as amended by Public Act No. 91-535 (August 13, 1999), defines "sales finance company" as including persons:

"primarily engaged in one or more of the following businesses: The business of purchasing customer receivables, the business of making loans upon the security of customer receivables, the business of making loans for the express purpose of funding purchases of tangible personal property or services by the borrower, or the business of finance leasing; . . ."

xxxxxxxxxxxxxxxxxxxx primary business will be the purchase of customer receivables from xxx and its subsidiaries. As such, xxxxxxxxxxxxxxx falls within the definition of a "sales finance company" as outlined in Section 1501(a)(8)(C) of the IITA.

The discussion above focuses on the provisions of Public Act No. 91-535. While this statutory language is effective January 1, 2000, it is also declaratory of existing law. Under the terms of Section 1501(a)(8)(c) of the IITA as currently written, we believe xxxxxxxxxxxx would also qualify as a sales finance company.

xxxxxxxxxxxxxxxxxxxx Interest Income

Under Section 1501(a)(8) of the IITA, a sales finance company is a type of financial organization. As a financial organization, xxxxxxxxxxxx would apportion its income to Illinois based on Section 304(c) of the IITA.

The particular apportionment rule of Section 304(c) of the IITA which seems relevant to the income of xxxxxxxxxxxxxxx is clause (1)(C) dealing with "interest from Illinois customers." xxxxxxxxxxxxxxx would earn income when customers make payments against their accounts receivable. These customer payments would permit xxxxxxxxxxxxxxx to realize amounts in excess of what it paid for the accounts receivable, the excess generally being equal to the discount from adjusted face value at which it purchased the accounts receivable from xxx and its subsidiaries. From the perspective of the customers of xxx and its subsidiaries, this discount would be a measure of the value of the financing that is implicit in the deferral of the sales

price for the products sold by xxx and its subsidiaries. Since this discount would be based on the prevailing market rates of interest and the creditworthiness of the customers of xxx and its subsidiaries, we believe that the recover of this discount would be interest within the meaning of Section 304(c)(1)(C) of the IITA.

xxxxxxxxxxxxxxxxxxxx Illinois Customers

As previously stated, xxx and its subsidiaries have wholesale and retail customers located throughout the United States including Illinois. The wholesale customers are either corporations that have multistate operations, with their respective headquarters located in a single state, or sole proprietorships or partnerships that operate out of one or more locations in a single state. There are also a small percentage of retail customers. (i.e. 1%).

Section 304(c)(1)(C) of the IITA requires financial organizations such as xxxxxxxxxxxxxxxx to determine business income from sources within Illinois by including only interest from Illinois customers which is received in Illinois. There is no express statutory definition or regulatory interpretation of the term "customer" or "Illinois customer" for purposes of Section 304(c)(1)(C) of the IITA.

In analyzing the Department's previously published pronouncements on the issue of "customer" and "Illinois customer" for purposes of Section 304(c)(1)(C) of the IITA, we are lead to the following two conclusions in determining the taxation of xxxxxxxxxxxxxxxx income from purchase of accounts receivable generated by the sale of office products to customers of xxx and its subsidiaries. First, xxx xxxxxxxxxxxx would look to the customers of xxx and its subsidiaries in making the determination of who are its customers. Second, xxx xxxxxxxxxxxx will treat customers of xxx and its subsidiaries who are individual Illinois residents or persons other than individuals whose commercial domicile is in Illinois as Illinois customers.

Though none of the Department's pronouncements on the Illinois customer issue discussed above are authoritative, they appear to us independently to be the most plausible construction of the statute.

xxxxxxxxxxxxxxxxxxxx Apportionment of Income to Illinois

Section 304(c) of the IITA includes items of income in the numerator of the Illinois apportionment factor, if they are "from sources within this State". In the context of interest from a financial organization's customers, the concept of "income from sources within" Illinois is further defined in Section 304(c)(1)(C) of the IITA to mean "interest from Illinois customers, which . . . (is) . . . received within this State."

As previously discussed, xxxxxxxxxxxxxxxx would receive interest payments from customers of xxx and its subsidiaries either electronically or by check at the lockbox locations, one of which is in Illinois. The banks at which the lockboxes are located would open the remittances, deposit the funds into the banking system and relay the paperwork to xxxxxxxxxxxxxxxx headquarters in xxxx for cash application.

There is no express statutory definition or regulatory interpretation of what constitutes receipt in Illinois. The Department has previously issued private letter rulings requiring interest payments made to Illinois locations by Illinois customers to be treated as received in Illinois for purposes of apportionment under Section 304(c)(1)(C) of the IITA.

xxxxxxxxxxxxxx will have a lockbox at an Illinois location to which the customers of xxx and its subsidiaries will make payments of interest. On behalf of xxxxxxxxxxxxxx, the Illinois financial institution would open these remittances, deposit the funds into the banking system and forward the paperwork to xxxxxxxxxxxxxx in xxxx for cash application. As to payments to this Illinois lockbox, under Section 304(c)(1)(C) of the IITA as it has been consistently construed by the Department, these would clearly be received in Illinois. Of these payments to the Illinois lockbox, those that are from Illinois customers (discussed above), would be included in the numerator of xxxxxxxxxxxxxx Illinois apportionment formula, with the result that xxxxxxxxxxxxxx would incur a liability for Illinois income and replacement tax.

SUMMARY [of the Taxpayer]

We anticipate that xxxxxxxxxxxxxx Illinois income tax liability would be determined on the following basis. xxxxxxxxxxxxxx would be a financial organization under Section 1501(a)(8) of the IITA. The recovery of the discount (as described above) by xxxxxxxxxxxxxx would properly be characterized as interest. xxxxxxxxxxxxxx would receive payments of this interest electronically or by check at the lockbox locations, one of which is in Illinois. The interest payments received at xxxxxxxxxxxxxx Illinois lockbox from customers of xxx and its subsidiaries who are individual Illinois residents or persons other than individuals who are commercially domiciled in Illinois would constitute business income from sources in the state under Section 304(c)(1)(C) of the IITA.

OPERATIVE DATE OF THE REQUESTED RULING

xxx and xxxxxxxxxxxxxx request that this ruling be applicable to their Illinois income tax liabilities for the fiscal year ending January 1, 2000 and all later tax years. There is no pending Illinois income tax audit of xxx or xxxxxxxxxxxxxx on the issues discussed in this ruling request.

Ruling

Section 1501(a)(8) of the Illinois Income Tax Act (the "IITA"; 35 ILCS 5/101 et seq.) defines the term "financial organization" as follows:

(A) The term "financial organization" means any bank, bank holding company, trust company, savings bank, industrial bank, land bank, safe deposit company, private banker, savings and loan association, building and loan association, credit union, currency exchange, cooperative bank, small loan company, sales finance company, investment company, or any person which is owned by a bank or bank holding company. For the purpose of this Section a "person" will

include only those persons which a bank holding company may acquire and hold an interest in, directly or indirectly, under the provisions of the Bank Holding Company Act of 1956 (12 U.S.C. 1841, et seq.), except where interests in any person must be disposed of within certain required time limits under the Bank Holding Company Act of 1956.

* * *

(C) For purposes of subparagraph (A) of this paragraph, the term "sales finance company" has the meaning provided in the following item (i) or (ii):

(i) A person primarily engaged in one or more of the following businesses: the business of purchasing customer receivables, the business of making loans upon the security of customer receivables, the business of making loans for the express purpose of funding purchases of tangible personal property or services by the borrower, or the business of finance leasing. For purposes of this item (i), "customer receivable" means:

(a) a retail installment contract or retail charge agreement within the meaning of the Sales Finance Agency Act, the Retail Installment Sales Act, or the Motor Vehicle Retail Installment Sales Act;

(b) an installment, charge, credit, or similar contract or agreement arising from the sale of tangible personal property or services in a transaction involving a deferred payment price payable in one or more installments subsequent to the sale; or

(c) the outstanding balance of a contract or agreement described in provisions (a) or (b) of this item (i).

A customer receivable need not provide for payment of interest on deferred payments. A sales finance company may purchase a customer receivable from, or make a loan secured by a customer receivable to, the seller in the original transaction or to a person who purchased the customer receivable directly or indirectly from that seller.

You have represented that virtually all of the business activities of xxx xxxxxxxxxx will be related to the purchase of customer accounts receivable from xxx and its subsidiaries. Under Section 1501(a)(8)(C) of the IITA, xxx xxxxxxxxxx will therefore be a sales finance company, which is a financial organization for purposes of the IITA.

Apportionment of Business Income of xxxxxxxxxxxxxxxx

Section 304(c)(1) of the IITA provides the basic apportionment rule for financial organizations, as follows:

Business income of a financial organization shall be apportioned to this State by multiplying such income by a fraction, the numerator of which is its business income from sources within this State, and the denominator of which is its business income from all sources. For

the purposes of this subsection, the business income of a financial organization from sources within this State is the sum of the amounts referred to in subparagraphs (A) through (E) following, but excluding the adjusted income of an international banking facility as determined in paragraph (2):

(A) Fees, commissions or other compensation for financial services rendered within this State;

(B) Gross profits from trading in stocks, bonds or other securities managed within this State;

(C) Dividends, and interest from Illinois customers, which are received within this State;

(D) Interest charged to customers at places of business maintained within this State for carrying debit balances of margin accounts, without deduction of any costs incurred in carrying such accounts; and

(E) Any other gross income resulting from the operation as a financial organization within this State. In computing the amounts referred to in paragraphs (A) through (E) of this subsection, any amount received by a member of an affiliated group (determined under Section 1504(a) of the Internal Revenue Code but without reference to whether any such corporation is an "includible corporation" under Section 1504(b) of the Internal Revenue Code) from another member of such group shall be included only to the extent such amount exceeds expenses of the recipient directly related thereto.

As this statutory provision is structured, a financial organization apportions its business income by first identifying each item of business income which is described in paragraphs (A) through (D). Those items are sourced to Illinois according to the applicable rule in paragraph (A), (B), (C) or (D), and all other items of business income are sourced to Illinois under the rule in paragraph (E). The total of items sourced to Illinois is then divided by the total of all business income of the taxpayer from all sources, and the result is multiplied by the taxpayer's business income to determine the amount apportioned to Illinois.

You have requested a ruling that the amounts received by xxxxxxxxxxxxxx from customers of xxx and its subsidiaries, to the extent those amounts exceed the amounts paid by xxxxxxxxxxxxxx for the respective accounts receivable purchased from xxx and its subsidiaries, will be sourced under Section 304(c)(1)(C) as interest income.

For federal income tax purposes, the United States Supreme Court has defined "interest" to mean "compensation for the use or forbearance of money." *Deputy v. du Pont*, 308 U.S. 488, 498 (1940). Pursuant to Section 102 of the IITA, this definition of the term "interest" for purposes of the Internal Revenue Code also applies to the term "interest" as used in the IITA. As you have described the transactions by which xxxxxxxxxxxxxx will acquire the accounts receivable from xxx and its subsidiaries, xxxxxxxxxxxxxx will acquire all rights to payments on the receivables, without recourse, for a cash price determined by the market rate of interest at the time of the purchase, the expected time and amount of payment on the receivables, and the creditworthiness of obligors on the

receivables. Accordingly, the amounts received by xxxxxxxxxxxxxx from the customers of xxx and its subsidiaries, in excess of the amounts it has paid for the respective accounts receivable, will be compensation received entirely in exchange for the use of xxxxxxxxxxxxxx money and will reflect the factors normally taken into account in determining the amount of interest payable on an advance of funds. Such amounts will therefore be interest for purposes of the IITA, and their allocation will be governed by Section 304(c)(1)(C) of the IITA.

Under Section 304(c)(1)(C) of the IITA, interest income is sourced to Illinois only if it is from an Illinois customer and received in Illinois. The term "customer" is not defined in the IITA or in any relevant authority, and the definition is the proper subject for rulemaking. However, pending the promulgation of a regulatory definition, under the facts described in your request, the obligors on the accounts receivable will be customers of xxx xxxxxxxxxx. The obligors are all customers of xxx and its subsidiaries, which will be making credit sales in the expectation of selling the accounts receivable to xxxxxxxxxxxxxx. Because xxxxxxxxxxxxxx is affiliated with xxx and its subsidiaries and will be buying the accounts receivable (rather than making a loan to xxx and its subsidiaries secured by the accounts receivable) in transactions fully anticipated at the time the accounts receivable are created, the obligors on the accounts receivable will become customers of xxxxxxxxxxxxxx at the time the accounts receivable are purchased.

The term "Illinois customer" also is not defined in the IITA or in any relevant authority, and is also the proper subject for rulemaking. Pending the promulgation of regulations on this issue, the following principles should be applied. First, the term "Illinois customer" will include any individual customer who is a resident of Illinois and any person (other than an individual) who is commercially domiciled in Illinois. Second, if the taxpayer has no actual knowledge of the residence or commercial domicile of a customer, the customer will be presumed (subject to rebuttal) to be an Illinois customer if the billing address of the customer is in Illinois.

The term "received in this State" in Section 304(c)(1)(C) of the IITA is undefined, and is the proper subject for rulemaking. Pending promulgation of regulations on this issue, interest from xxxxxxxxxxxxxx Illinois customers will be "received in this State" if the payment is sent by the customer to a lockbox located in Illinois or the electronic funds transfer from the customer is directed to a bank located in Illinois.

In summary, the amounts xxxxxxxxxxxxxx receives from obligors on accounts receivable purchased from xxx and its subsidiaries in excess of the amounts paid by xxxxxxxxxxxxxx for the accounts receivable will be interest income which will be sourced to Illinois if:

- (a) the customer is:
 - (i) an individual Illinois resident; or
 - (ii) a person (other than an individual) whose commercial domicile is in Illinois; or
 - (iii) (subject to rebuttal) any person whose billing address is in Illinois if xxxxxxxxxxxxxx has no knowledge of the person's residence or commercial domicile; and
- (b) the customer's payment is sent by the customer to the lockbox in

Illinois.

Note that payments made by a credit card company (or any other third party) on behalf of a customer are payments from the customer, and should be sourced according to the same rules as payments made directly by the customer.

The facts upon which this ruling are based are subject to review by the Department during the course of any audit, investigation or hearing and this ruling shall bind the Department only if the material facts as recited in this ruling are correct and complete. This ruling will cease to bind the Department if there is a pertinent change in statutory law, case law, rules or in the material facts recited in this ruling.

Very truly yours,

Paul Caselton
Deputy General Counsel -- Income Tax